

INVESTMENT ADVISORY COUNCIL
Wednesday, August 8, 2012

MEETING NO. 397

Members present:

Thomas Barnes
Janice (Jan) Carpenter
Thomas Fiore, representing Benjamin Barnes*
Laurence N. Hale
Joshua Hall
David (Duke) Himmelreich*
William Murray
Denise L. Nappier, Treasurer**
Joseph (Joe) D. Rixe, Chairman
Peter Thor***

Absent:

Michael Freeman
Carol Thomas

Others present:

Christine Shaw, Deputy Treasurer
Lee Ann Palladino, Chief Investment Officer
Gary Carter, Interim Deputy Chief Investment Officer
Catherine LaMarr, General Counsel
Shelagh McClure, Director of Compliance
Terrence Purcell, Interim Principal Investment Officer
Donald Kirshbaum, Investment Officer-Policy
Reginald Tucker, Investment Officer
Linda Tudan, Executive Assistant
Winifred (Winnie) Scalora, Administrative Assistant

Intern:

Jeffrey Weldon

Guests:

Mary Dunleavy, State Street Bank & Trust
Sean Gill, NEPC
Will Greene, Loop Capital Markets
Robin Kaplan-Cho, Connecticut Education Association
Louis Laccavole, SOC Teachers' Retirement Board
Claire Shaughnessy, Hewitt EnnisKnupp, Inc.
Johnson Shum, State Street Bank & Trust
Diane Smola, Hewitt EnnisKnupp, Inc.
Robert Steyer, Pensions and Investments
Jennifer Thomas Becker, Armstrong Shaw Associates Inc.
Kevin Vandolder, Hewitt EnnisKnupp, Inc.

Chairman Joseph D. Rixe called the Investment Advisory Council ("IAC") meeting to order at 9:00 a.m.

* Arrived at 9:02 a.m.

** Arrived at 9:10 a.m.

*** Arrived at 10:03 a.m.

Approval of Minutes of the June 13, 2012 IAC Meeting

With a quorum present, Chairman Roxe asked for comments on the Minutes of the June 13, 2012 IAC meeting. **There being no comments, a motion was made by William Murray, seconded by Janice Carpenter, that the Minutes of the June 13, 2012 IAC meeting be accepted as drafted. The motion was passed with the exception of Thomas Barnes, Thomas Fiore and Laurence Hale who abstained due to their absence from the last meeting.**

Update on the Market and the Connecticut Retirement Plans and Trust Funds Final Performance as of May 31 and June 30, 2012

Lee Ann Palladino, Chief Investment Officer (“CIO”), provided an update on the capital market environment, its impact on the investment performance of the Connecticut Retirement Plans and Trust Funds (“CRPTF”) and the economic outlook, which was followed by a report on the performance for the CRPTF as of May 31 and June 30, 2012. Before she began her presentation, Ms. Palladino said that Claire Shaughnessy and Kevin Vandolder, Partners of Hewitt EnnisKnupp, Inc. (“Hewitt”), would provide a peer review presentation. She remarked about three items of importance when examining the peer review report: (i) the asset allocations, which were customized as a result of an Asset Allocation and Liability Study (“A/L Study”); (ii) the Combined Investment Fund’s (“CIF”) structure to meet the capital market return and risk projections; and (iii) the CRPTF is a long-term investor and performance is typically judged over a market cycle of three to five years.

Ms. Palladino recapped the Fiscal Year 2012 (“FY 2012”) market events, and she reported that the CRPTF’s investment performance for the quarter ended June 30, 2012 dragged the fiscal year-to-date earnings down to negative 90 basis points (“bps”); she added that the returns for the three, five and ten-year horizons were all positive. She noted that during FY 2012 the events in Europe heavily influenced market sentiment and performance. Ms. Palladino reported that FY 2012 began with a market value of \$25.2 billion and ended at just under \$24 billion, a 4% decline, which was largely attributable to benefit payments that were greater than contributions, and accounted for \$1 billion of the \$1.2 billion decline.

Ms. Palladino commented that falling interest rates had been beneficial for the fixed income funds, which made up 23% of the CRPTF’s investments and earned about 7.82%. She said that the CRPTF’s overall equity exposure was about 55%, split between U.S. and international markets, and returned negative 5% for FY 2012 due to the declines associated with investment in foreign markets. Regarding the alternative investments, comprised of the Alternative Investment Fund (“AIF”), Private Investment Fund (“PIF”) and Real Estate Fund (“REF”), Ms. Palladino reported that total investments were about \$4.4 billion and posted earnings of 5.3%, which were helped by the rebounding real estate and private investment markets. Overall for FY 2012, she said that the CRPTF’s asset allocation was well diversified and noted that the fixed income funds and all of the alternative asset classes, which represented 45% of the CRPTF, posted positive returns which were offset by 55% of the equities which were down, leaving FY 12 performance virtually flat.

Ms. Palladino reviewed the liability profiles for the Teachers' Retirement Fund ("TERF"), State Employees' Retirement Fund ("SERF") and Municipal Employees' Retirement Fund ("MERF"). Next, she recapped the performance of each CIF compared to its respective benchmark, and discussed the CRPTF's investment strategy for each CIF. In response to David Himmelreich's question regarding the emerging market debt swings, Ms. Palladino said that investment in local currencies caused the deviation as the CRPTF benchmark was denominated in U.S. dollars.

Next, Ms. Shaughnessy and Mr. Vandolder presented an analysis of the CRPTF's performance versus its peer group universe. Mr. Vandolder stated that the peer universe used by Hewitt included certain public plans with assets greater than \$1 billion. He said that comparing peer data allowed for the performance of the CRPTF to be evaluated against other public pension plans. Mr. Vandolder noted that looking at peer data is a snapshot in time, and dependent upon the horizon, the results may change dramatically. He said that the performance of the TERF, SERF and MERF came in at the median range, second quartile, or slightly higher versus the peer group during the quarter and 12-month period ended March 31, 2012; it was in the third or fourth quartile for the calendar year, three, five and seven-year horizons.

Ms. Shaughnessy noted that the broad based data provided by Hewitt found that the U.S. Equity, International Equity and U.S. Fixed Income portfolios all ranked well above median, falling in or near the top third of peer results for FY 2012.

Chairman Roxe pointed out that the TERF, SERF and MERF had below median performance for many time horizons versus the peer universe. He said the pattern was of concern considering that the A/L Study was just completed and there was very little change to the overall asset allocation. Chairman Roxe requested Ms. Palladino to provide a list of implementable ideas that could afford fine tuning and add value to the CRPTF. Mr. Himmelreich cautioned that while the asset allocations remained similar, it was important to remember that the CRPTF was a long-term investor and it was necessary to remain committed to the long-term objectives outlined in the A/L Study. Discussion ensued regarding the results of the peer analysis, its caveats such as differences in asset allocation, risk tolerance, plan demographics and other legal or statutory restrictions, which may affect performance results and the positioning of the portfolio going forward. Ms. Palladino said that the next step in the investment process, after completion of the A/L Study, was to review each of the CIF and evaluate its structure with the goal of improving performance.

Comments by the Treasurer

Treasurer Denise L. Nappier commented on the orientation session that was provided on July 16, 2012 for IAC members Ms. Carpenter and Joshua Hall. Next, she announced that Donald Kirshbaum, Investment Officer for Policy, was retiring from State service effective September 1, 2012, and she spoke about his many contributions during his tenure at the Office of the Treasurer ("OTT"), which spanned several Treasury administrations. Treasurer Nappier then invited everyone to join her in thanking Mr. Kirshbaum for all of his contributions and in wishing him the very best as he begins the next chapter of his life.

Next, Treasurer Nappier announced that she had made two commitments after considering the feedback from the IAC and the OTT's extensive due diligence process conducted by investment staff and the consultants for the REF and the PIF; The Townsend Group and Franklin Park Associates, LLC, respectively. She said that she would commit up to \$100 million to Cornerstone Patriot Fund, a \$1.4 billion core real estate fund headquartered in Hartford that was targeting low-leveraged core properties with a primary focus on stable, income-producing U.S. commercial real estate investments. Treasurer Nappier also announced that she would commit up to \$25 million to SW Pelham IV, L.P., a \$250 million private equity fund managed by Smith Whiley & Company, also headquartered in Hartford, that focused primarily on mezzanine debt and targeted companies operating in the industrial, business services, healthcare, food and beverage, consumer products, communications and technology sectors primarily in lower middle markets. She added that both commitments were contingent upon successful contract negotiations.

With respect to the agenda, Treasurer Nappier commented on the most recently posted performance of the CRPTF, current events and the adopted amendments to the Investment Policy Statement ("IPS"). She said that while the 2012 fiscal year returns for the CRPTF were virtually flat, net of fees, the calendar year-to-date returns were healthier at 5.67%. She also highlighted the three-year return of 10.54% as of June 30, 2012, which was above the assumed rate of return of 8.25% to 8.50%. Treasurer Nappier commented that the "Great Recession" was not a hit-and-run event, but an unprecedented financial crisis, and that it was important to be mindful that events in Europe and beyond have had and would continue to have far-reaching consequences for investors in a global economy.

Turning to other current events, Treasurer Nappier said that there had been a lot of recent coverage regarding London Interbank Offered Rate ("LIBOR") alleged rate-fixing, and she noted that her July 18th press release addressed the steps the OTT was taking to assess the impact of the event on the CRPTF and the State. She said that the scandal resulted in the resignation of the Barclays' Chairman, the CEO and the COO, and raised more questions among the media and other regulatory authorities with regard to the possibility of widespread collusion among banks. She also said that the LIBOR manipulation had the potential to touch upon the many ways in which business is practiced within Treasury – whether through investment of pension funds, short-term investments, or pricing of the State's debt because the Treasury was exposed to LIBOR rates, and could be on either side of a buy/sell transaction. Treasurer Nappier noted that the OTT was currently conducting a preliminary review of the potential impact of the LIBOR rate manipulation; however, given the broad usage of LIBOR, it was difficult to calculate what the precise impact any rate fixing manipulation could have had during that period. Nonetheless, she said the OTT would continue to review the alleged rate manipulation and its potential gain or loss on the transactions conducted by, or on behalf of, the OTT.

Treasurer Nappier then discussed the Request for Comment by Moody's Investors Service ("Moody's") regarding a white paper it issued in early July entitled "Adjustments to U.S. State and Local Government Reported Pension Data." She said that Moody's requested feedback on its proposal to implement several calculation adjustments to the pension liability and cost information reported by state and local governments and their pension plans as a means for Moody's to

compare data among various plans. Treasurer Nappier said that according to reports prepared by Moody's, the adjusted calculations would result in a reduction in the funding ratio of 44% to 27% for SERF and 61% to 36% for TERF. She noted that while she believed it was important to utilize appropriate and realistic assumptions, Moody's approach was fraught with the potential for unintended consequences; she added that application of its calculation adjustments would conflict with the recently released guidance of the nationally recognized Government Accounting Standards Board, "GASB", which stipulated best practices for pension fund calculation methodology. Treasurer Nappier said that Moody's approach also left open the possibility of its results being misinterpreted by investors and it ignored Connecticut's requirement to fully fund the Annual Required Contribution, based on the re-valuation of the most recent data, which is done every two years. She added that Moody's approach placed it in the role of an actuarial firm rather than what it is – a credit rating agency. Finally, Treasurer Nappier said that Moody's was accepting comments regarding its proposed methodology. As a member of both the Teachers' Retirement Board and the State Employees Retirement Commission, Treasurer Nappier said that she forwarded Moody's proposal to each entity, and urged each of them along with their actuary, Cavanaugh Macdonald, to review Moody's proposal and offer comment, and that the OTT would do likewise.

Finally, Treasurer Nappier said that the amendments to the IPS, which she formally adopted, would be presented for the IAC's vote today. She said that this was the final step in the process that began last fall with the commencement of the A/L Study, and she thanked all the IAC members for their insight and the time they devoted to the A/L Study, followed by the final IPS document. Treasurer Nappier noted that while the amendments did not materially change the overall direction of the IPS, the lion's share of revisions were made to provide clear and unambiguous use of terms and concepts found in the IPS and to provide for greater flexibility to adjust to prolonged market volatility, both in terms of the policy weight and strategy of the asset and sub-asset class levels. She said that this policy specifically enabled increased exposure to opportunistic strategies for virtually every asset class. Treasurer Nappier noted that the asset allocation and expected investment return was consistent with the return assumption as established by the fund actuaries. She compared this A/L Study to the last study and highlighted the slightly higher risk profile and lower probability of achieving the return assumption inherent in the current A/L Study. She remarked that while the OTT had and would continue to stand by this asset allocation, she believed that the respective State pension boards should reconsider the merits of lowering the assumed rate of return during its upcoming valuation. Treasurer Nappier said that if the boards lowered the performance expectations, she would highly recommend the consideration of probable changes to the asset allocation with a focus on increasing the likelihood of meeting the boards' return assumption.

Next, Catherine E. LaMarr, General Counsel, commented on pending litigation against Amgen Inc., and said that OTT was the lead plaintiff in this class action litigation that resulted in statements by the company's management regarding the safety of its flagship products. She said that the oral argument would be heard by the U.S. Supreme Court on November 5, 2012, and that outside counsel had been hired to represent the CRPTF and to present the oral argument.

Christine Shaw, Deputy Treasurer, commented on the pending action by the state of New York's banking regulators against Standard Chartered Bank in order to revoke its license by virtue of allegations that it had disguised about \$250 billion worth of transfers over a six-year period of time in violation of U.S. sanctions against Iran. Deputy Treasurer Shaw said that the CRPTF did have some exposure to Standard Chartered Bank with holdings of about \$50 million of its securities, as well as some short-term cash equivalents in the Liquidity Investment Fund; she noted that the OTT had been in contact with its managers that held these positions, and in accordance with the existing contracts were determining whether they had knowledge of the bank's activities. Deputy Treasurer Shaw said that as part of the OTT's compliance protocols, a standard contractual provision included the ongoing obligation of the managers to make periodic assessments of the holdings of the securities in the CRPTF's portfolio as well as providing in-house certifications to the OTT that managers were in compliance with these protocols. She added that all money managers involved were compliant with the certifications and the OTT was in the process of preparing certifications for 2012. Deputy Treasurer Shaw noted that in addition to the standard contractual provision that obligated managers to scrutinize the portfolio, the OTT's staff regularly checked with the federal Office of Foreign Assets Control, and Standard Chartered Bank was currently not on the prohibited list and was not a prohibited investment. In response to Chairman Roxe, she said that the \$50 million was in corporate bonds and equity holdings. Discussion ensued regarding whether the parent company or the subsidiary held the CRPTF's assets.

Consideration of the Treasurer's Adopted Amendments to the Investment Policy Statement

Chairman Roxe stated that the amendments to the IPS, which were adopted by Treasurer Nappier on July 24, 2012, in substantially the form of the Treasurer's recommended revision to the IPS as presented at the June 13, 2012 IAC meeting, needed to be considered for approval by the IAC and asked if any of the IAC members had questions or issues with the final IPS.

Chairman Roxe then called for a motion to approve the Treasurer's July 24, 2012 adopted amendments to the IPS. **Peter Thor moved to approve the adopted amendments to the Investment Policy Statement. Mr. Barnes seconded the motion. The motion was passed unanimously to approve the amendments to the Investment Policy Statement as adopted by Treasurer Nappier.**

Securities Lending Review as of June 30, 2012

Johnson Shum, Vice President of State Street Bank, provided a review of securities lending activity for the quarter and fiscal year ended June 30, 2012. Mr. Shum reported that the historical earnings for FY 2012 were \$18.5 million, outpacing FY 2011 by 13.6%. He said that the return on lendables for FY 2012 had increased by 12.89 bps, outpacing FY 2011 by nearly 15.8%; he also commented on the top ten borrowers for the State of Connecticut. Mr. Shum explained the difference between a collateral spread and a funding spread, per Chairman Roxe's request. He then commented on LIBOR exposure as a source for manipulation, in response to Mr. Hale's question.

Corporate Governance and MacBride Compliance

Mr. Kirshbaum reported on Corporate Governance and MacBride Compliance for the quarter ended March 31, 2012. First, he spoke about his 19 years of service at the OTT and thanked Treasurer Nappier and the IAC for all their support in the corporate governance areas and noted Connecticut's leadership role in promoting corporate governance nationwide. He then reported that the OTT's votes were consistent with prior quarters in terms of the number of its votes against management and all firms were in compliance with the MacBride Principles. Mr. Kirshbaum commented on the recently passed legislation regarding the McBride statute, effective October 1, 2012, that made it compatible with the Sudan and Iran statutes and would allow for discretionary divestment.

Mr. Kirshbaum spoke about significant outcomes of the 2012 proxy and shareholder activism season in the areas of proxy access, disclosure of political expenditures and board diversity. Finally, Mr. Kirshbaum remarked about the concern for lack of board oversight of management, and he said that Treasurer Nappier had sent letters to companies addressing the issue. Chairman Roxe praised Mr. Kirshbaum for his excellent corporate governance work during his tenure at the OTT.

Other Business

Chairman Roxe invited the IAC members to submit agenda items for the September 12, 2012 IAC meeting.

Comments by the Chairman

Chairman Roxe commented on the meeting.

There being no further business, the meeting was adjourned at 10:44 a.m.

This meeting was electronically recorded.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "Denise L. Nappier", written in a cursive style.

DENISE L. NAPIER
SECRETARY